

**Statement of  
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Before the  
Subcommittee on Capital Markets, Insurance,  
and Government Sponsored Enterprises  
Committee on Financial Services**

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Chairman Baker, Congressman Kanjorski and members of the Subcommittee, I am Marc Lackritz, president of the Securities Industry Association.

I am very pleased to have this opportunity to meet with you today. This Subcommittee is addressing a very important issue. It is an issue of great concern to the investment banks, broker-dealers and mutual funds that make up the securities industry.

The subject of today's hearing concerns how this industry fulfills its obligations to its customers – to the nearly 80 million Americans who directly or indirectly own shares of stock. Our most important goal is to foster the trust and confidence of America's shareholders in what we do and how we do it. We want to address directly their questions and allay any doubts that may exist.

As SIA's By-Laws clearly state, "SIA member firms hold these values: adherence to ethical and professional standards, commitment to the best interests of clients; and exercise of unquestioned integrity in business and personal dealing in the industry and with the firms."

We succeed as an industry only when we succeed for investors. We succeed only when we serve investors in ways that help them reach their investing and saving goals. Period.

To this end, we in the industry have just adopted and released a *Best Practices for Research*. These *Best Practices* explicitly confront the matter before this panel: The role of the securities analyst. The details of the *Best Practices*, which I'll discuss in a moment, reaffirm and restate forcefully the best means to protect the independence of securities analysts and to ensure the objectivity of their important work.



First, however, you may ask: "Who are these securities analysts? And what do they do?"

Once a fairly unnoticed, even obscure, group, securities analysts have grown in visibility – even, at times, to prominence – in the past decade. There are a couple of reasons for this. For one, the sustained bull market spawned something of an equity culture in America. For another, advances in technology, online trading and the increased concern about saving for retirement all have democratized shareholding, creating a massive audience for the research by securities analysts.

Information is the lifeblood of our markets. The information that analysts provide contribute to this flow of information that originates from many sources. As the SEC acknowledged in a November 1998 statement: "Analysts fulfill an important function by keeping investors informed." When we read or hear on TV that a brokerage firm downgrades the XYZ Corporation or that Acme Communications' new design for fiber optic cable is expected to increase sales revenue due to improved performance, it is the securities analyst who renders this judgment.

How do securities analysts do what they do?

Analysts are themselves highly educated professionals. Most have advanced degrees and many have degrees in the fields to which they devote their research. Securities firms understand that it isn't possible to evaluate a new gene splicing company or a computer chip manufacturer without an extensive scientific background. Securities firms hire this kind of talent so that they can evaluate investment opportunities thoughtfully and wisely.

Analysts do lots of detective work. They immerse themselves in the dozen or so companies they each cover, scrutinizing the balance sheets and management, eyeballing the products or services the company produces, visiting the stores or other outlets where the products are sold, talking to customers and suppliers, getting a sense of the industry of which the company is part -- and much more. They literally kick the tires. As the 1998 SEC statement explains: "They digest information from Exchange Act reports and other sources, actively pursuing new company information, put all of it into context, and act as conduits in the flow of information."

In this process, the analysts also assess the specific economic sector in which that company operates and they take the pulse of the overall economy and try to figure out how that will affect the company. Then they roll-up all this information, run it through their evaluation models and draw their conclusion. This is the objective, quantifiable part of the process.

Then there is the subjective, gut-feeling -- even creative -- part. Though impossible to measure, securities analysts draw on their experience viewing economic cycles and fads, watching companies thrive and flounder, looking managers and CEOs in the eye and engaging in a host of other hands-on activities.

From this process they attempt to project the near term and, much more important, long-term economic health, viability and prospects of the firms. Then, typically, they take these projections and other performance criteria and apply to them a number of analytic measurements from which they make their assessments. Much of the time these are assessments of how the companies will perform.

There is great value added by securities analysts. For one thing, they uncover, sort through, digest and give structure to vast amounts of data. For another, their experience and their immersion in the deep workings of an industry give them the skills to look at highly technical data -- for example, the laboratory results in trials of new medicines, or the production processes for a new jet engine -- to draw conclusions from this and to explain them in terms that investors can understand.

This process and the value added by securities analysts have been appreciated widely. For example, the United States Supreme Court and the SEC have both said that "[t]he value to the entire market of analysts' efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by their initiatives to ferret out and analyze information, and thus the analysts' work redounds to the benefit of all investors." *Dirks v. SEC*, 463 U.S. 646, 659 n. 17 (1983) (quoting 21 S.E.C. 1401, 1406 (1981))



How good a job, you could ask, do securities analysts do?

As a group, they do pretty well. A recent academic paper (published in the April issue of the *Journal of Finance* and then updated in May)<sup>1</sup> reviewed approximately 500,000 analyst recommendations from 1986-2001, and concluded that the consensus recommendations that analysts make on specific stocks prove prescient and profitable. The authors found “sell-side analysts’ stock recommendations to have significant value”.

Aside from this comprehensive study, it is notable that 71% of recommendations listed in First Call are “buys” or “strong buys.” This seems appropriate, considering that the 12 years from 1988 through 1999 saw the Dow Jones Industrial average and the Standard & Poors 500 index both post an average gain of 16% a year. Critics of analysts were much less vocal then.

To be sure, in the past year or so, as the market declined and the Internet bubble burst, it seems that securities analysts have a few bloodied noses. They do. And they are not alone. Just about everyone working in, reporting on and commenting about securities recently has tripped at least a few times. But, of course, it’s not only in the investment world in which bad years distressingly and abruptly interrupt a string of good. Michael Jordan, Babe Ruth, Tiger Woods, Tom Cruise, -- all superstars -- have occasional bad times, even bad years.

This is not to say that all securities analysts are in the Tiger Woods category. As individuals, their performances vary, with some doing better than others. This is to be expected for, as we noted, analyzing companies, assessing their prospects and projecting their performance is an art as well as a science. Some securities analysts make wrong calls more than they would like. But here it is important to emphasize three points.

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<sup>1</sup> “Can Investors Profit from the Prophets? Security Analysts Recommendations and Stock Returns” *Journal of Finance*, Vol. LVI, no. 2, April 2001, covered the period 1985 to 1996 and a database of 360,000 separate pieces of advice from 269 brokerage houses and 4,340 analysts over this 10 year period. “Prophets and Losses: Reassessing the Returns to Analysts’ Stock Recommendations” *Journal of Finance*, May 2001, updates the study, covering the period 1997-2000. Although investors would have outperformed the market indexes following the consensus recommendations of analysts, to implement this trading strategy would require buying and selling stocks frequently—since so many analysts were included in the study and they changed their recommendations frequently, with turnover rates at times in excess of 400% annually would produce significant transaction costs. In other words, analysts do a good job picking stocks, but an investor following all their recommendations would incur commissions and other costs, such as taxes, that could reduce the investor’s performance to that of the market indices. This is not to say that analysts’ recommendations are not valuable. As the authors point out, “there is one group of investors who can take advantage of our findings—those who are otherwise considering buying or selling, and so will be incurring transaction costs in any case. For these investors, analysts’ recommendations remain valuable.”

In the update, the years 1997-1999 produced similar results. However, the results for 2000 were strikingly different. “After a string of years in which security analysts’ top picks significantly outperformed... the year 2000 was a disaster,” with the recommendations producing significantly worse results than the market indexes. However, the author termed these results a “mystery” or a true outlier, and “we cannot conclude that these results (2000) are necessarily driven by increased analyst involvement in investment banking”.

One. To be wrong in projecting the performance of a company or a security is very different from failing to try their hardest to serve the interests of investors. It is very different from allegedly succumbing to pressures to tilt one way or another in their analyses and projections.

Two. Similarly well-trained, experienced and even wise analysts can differ over how much weight to give such otherwise seemingly objective facts as the company's sales figures, gross (or net) revenues, debt, inventory levels, cost of customer acquisition and a host of other data. For example, some analysts may hail as good news a change in a company's top management while others may see it as a cautionary yellow flag of trouble ahead. That's why we have a market – to clear these conflicting views every day and at an agreed-on price. And the market and investors do a remarkably good job of sorting out the good assessments from the bad.

Three and most important. Even if analysts agree on what is going on inside a company, they may differ in their reading of the macro environment in which that company operates. This environment – a specific sector (such as autos or computers), or a broad sector (such as technology or capital goods), or a geographical region or even the economy as a whole – can influence enormously how the company performs.

The question before this Subcommittee is whether, as they conduct their research, can these analysts be subjected to direct or subtle pressure to skirt objectivity and shade their conclusions one way or another? This is a legitimate question. The answer is: “Yes they can.” We in the industry as well as those who regulate us long have been well aware of this. For this reason, there are strong legal mandates in the Securities Exchange Act of 1934 and similar regulations and laws are on the books to ensure research integrity and objectivity. Some of the more important of these requirements include the following provisions:

- Section 15(f) of the Exchange Act provides that firms must have systems reasonably designed to prevent insider trading.
- New York Stock Exchange (“NYSE”) Rule 472 provides that firms must have a reasonable basis for making a recommendation.
- NASD Rule 2210(d)(2)(B) and Interpretation .40(2) of NYSE Rule 472 direct firms, in publishing a recommendation, to disclose certain situations that could pose a conflict of interest, such as whether the firm makes a market in the security, whether the firm was a managing or co-managing underwriter of a public offering of the issuer's securities within the past three years, whether the firm or its employees involved in preparing the research report may have a position in the securities or options of the recommended company, or whether an officer or employee of the firm is a director of the company being recommended.
- NASD Rule 2210 (d)(2)(B)(ii) requires that the broker-dealer shall provide available information supporting the recommendation.
- The NASD and NYSE have both advised their members that broker-dealers are prohibited from accumulating positions in NYSE-listed or NASDAQ-listed

securities in advance of a research report for the purpose of selling to investors who receive the research report. See NYSE Information Memo 91-8; NASD NTM 95-75.

- Analysts are also generally subject to “quiet periods” barring them from issuing research on a company while the analyst’s firm is acting as an underwriter for a registered offering of the company’s securities. There are carefully tailored exceptions to this prohibition contained in SEC Rules 137, 138 and 139. The goals of these rules are to balance the need of investors for timely research with the need to ensure that a research report does not “gun jump” a securities offering, and does not induce purchasing that would artificially boost the price in the aftermarket.

Firms themselves have adopted checks and balances to ensure the integrity of their operations. The *Best Practices* described below came, in most instances, from the firms.

These are tough regulations, as are the internal safeguards. Yet, it is clear that some doubts now may be clouding the perception of how securities analysts operate. That is why we’re meeting today. It is to banish these clouds that the Securities Industry Association has formalized and bolstered the safeguards by endorsing and releasing earlier this week these *Best Practices for Research*

In these, we articulate clearly the means to protect the independence and objectivity of securities research and the securities analysts.

We make an unambiguous re-commitment that analysts’ judgments are to be dictated solely by the data they find and by the insights they bring through their years of experience.

We reaffirm that the securities analyst serves only one master: The investor. Not the issuer or the potential issuer.

While this new statement of *Best Practices*, forcefully reaffirms many safeguards and procedures already in place, it is far more than a reaffirmation. It is a loud, clear declaration by us – louder and more explicit and more precise than ever before -- that there should be and can be no doubt that the primary role of securities research is to amass, assess and analyze data that ultimately inform individual and institutional investors so that they become wiser investors. Nothing the analyst does can be in conflict with this preeminent responsibility.

The *Best Practices* make our commitment unambiguously clear. It is the investing client who comes first. Once we established that critical element, the rest of the Practices flow logically. Let me offer some examples from its main points:

One. The integrity of research should be fostered and respected throughout a securities firm. Each firm should have a written statement affirming a commitment to the integrity of research.

Two. The firm, research management, analysts, investment bankers, and other relevant constituencies should together ensure the integrity of research, in practice and in appearance.

Research should not report to investment banking. Recommendations should be transparent and consistent. A formal rating system should have clear definitions that are published in every report or otherwise readily available, and management should support use of the full ratings system.

Three. No outside or investment bank approval of investment recommendations. An analyst should not submit research to investment banking or to corporate managements for approval of his or her opinions or recommendations. Nor should business producers promise or propose specific ratings to current or prospective clients when pursuing business. The SEC recognized the great value of analyst objectivity when it declared in 1998: “Where analysts are acting independently and objectively, investors gain from the publication of their insights.”

Four. A research analyst’s pay should not be directly linked to specific investment banking transactions.

Five. Research should clearly communicate the relevant parameters and practical limits of every investment recommendations. Analysts should be independent observers of the industries they follow. Their opinions should be their own, not determined by those of other business constituencies.

Six. Disclosures should be legible, straightforward and written in plain English. Disclaimers should include all material factors that are likely to affect the independence of specific security recommendations.

Seven. Personal trading and investments should avoid conflicts of interest and should be disclosed whenever relevant. Personal trading should be consistent with investment recommendations.

There are a number of other important points in the *Best Practices*, copies of which I am submitting to this Subcommittee.

I must note that SIA’s *Best Practices for Research* are not binding on its members. SIA is not a regulator. The anti-trust laws impose limits on a trade association’s ability to set standards. But the fourteen largest firms engaged in 95% of underwriting in the U.S. have endorsed these *Best Practices*, from their top management, including their CEOs, to their research departments. That in itself is a remarkable achievement in only a few months’ time.

Congress, the SEC, the SROs, and other regulators should give these best practices an opportunity to work. By developing this consensus set of *Best Practices*, SIA members have reaffirmed and formalized the commitment that is implicit in existing rules and regulations.



Let me conclude by repeating what I stressed earlier. The securities analyst will serve only one master: The investor.

We also pledge to continue and expand our investor education efforts so that investors well understand the risks and rewards inherent in the market as well as the basic investment

precepts. The Securities Industry Association and our member firms, through such publications as *Your Guide to Understanding Investing*, *Investor Topics*, *Understanding Market Risks* and *Managing Your Expectations* and through elaborate interactive websites, already devote considerable resources and attention to educating investors. We plan to devote even more effort.

This is very important because no matter how much we in the securities industry do by ourselves, we can contribute only half of the ingredients needed for successful investing. This is because successful investing is a partnership – a partnership between securities professionals and the investor.

Therefore, just as the securities industry is renewing its commitment to do its part, we ask investors to take at least two important steps to ensure that they are doing their part.

First, remind yourself that among securities analysts there are almost always differing opinions about the prospects of an individual company. Look at and evaluate the differing opinions. Deal with actions that affect your financial health just as you would with those affecting your physical health. Consider getting a second opinion. And just as you would check out the reputation of your doctor, check on the securities analyst. They have track records and compete with each other based on these records. In fact, the competition is growing more intense, as such publications as *The Wall Street Journal* and *Institutional Investor* and as websites compare individual analysts' performances, and rate them.

Second. Remind yourself that a securities analyst's assessment of a company is just one of a number of factors that you should consider when investing your money. You should do your own assessing -- from your own particular perspective. Ask yourself: Does stock of the company belong in your portfolio? Does it fit into your investment strategy? Do you have the risk tolerance for it? And so forth with the kind of questions only you and your financial advisors can answer. If you make your own investment decisions and do not seek professional investment advice, you must ensure that your decisions are well-suited to your situation. If you buy professional advice, such as through a full-service broker, you need to work with your registered representative to develop a strategy that makes sense for you.

We ask our customers, we ask investors: Help make our partnership work. Be an informed and prudent investor.



The long-term interests of the securities analysts and the securities firms for which they work are best served by analysts using their most skilled powers of research and best judgments. The market is a very powerful and unforgiving enforcer. Flawed projections lose customers.

All of us in this industry know only too well the truth of the adage that it takes months to win a customer but only seconds to lose one. All of us nod in agreement to Wal-Mart Founder Sam Walton's repeated advice to his managers: "There is only one boss – the customer. And he or she can fire everybody in the company from chairman on down, simply by spending his or her money somewhere else."



Indeed, ours is a fiercely competitive industry – not only among members of this industry but also between those of us who offer securities as a vehicle of investment and those who offer alternative forms of investment. No securities firm wants to give advice that will hurt a client. Firms that offer bad investment guidance penalize themselves.

We believe that the *Best Practices*, endorsed by so many major firms, demonstrate a vigorous renewed commitment to the investor. We hope they will go a long way towards ensuring that the public justly retains its trust and confidence in our markets and our industry.

Thank you very much.

